

SPRING 2010
Volume 1 Number 2

Forefront

New Ideas on Economic Policy from the FEDERAL RESERVE BANK
of CLEVELAND



A Proposal: Using the CRA to Fight Vacancy and Abandonment

INSIDE:

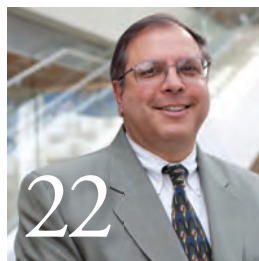
Credit for
Small Businesses

Systemic Risk

Q&A with
Economist
Anil Kashyap

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The Fed's Exit Strategy Explained



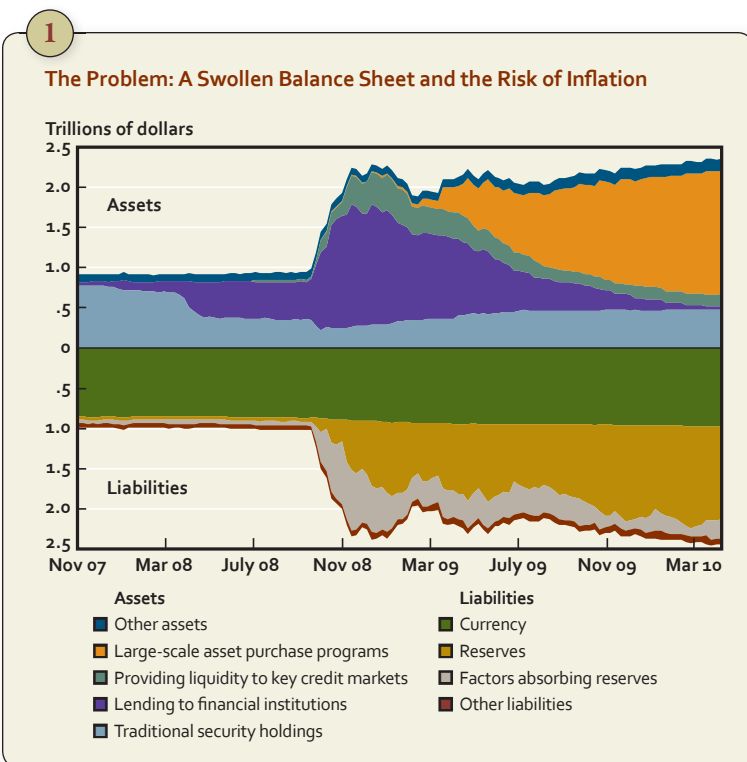
Mark S. Sniderman
Executive Vice President
and Chief Policy Officer

Beginning in 2008, the Federal Reserve purchased \$1.25 trillion worth of mortgage-backed securities, dramatically increasing the asset side of the central bank's balance sheet. The purchases helped drive down interest rates on private market credit, especially home mortgages, and were crucial to the effectiveness of the Federal Reserve's emergency efforts to save the economy.

Figure 1. But now there is more than \$1 trillion in excess bank reserves on balance at the Federal Reserve—that is, more reserves than necessary to meet the minimum requirements. Eventually, the time will come to mop up all that cash. The Federal Reserve will have to take steps to keep the bulk of excess reserves from entering the banking system all at once, because the quantity is far too large to keep inflation at bay in a healthy economy.

Figure 2. How can it do this? Congress recently granted the Federal Reserve the power to pay interest on reserves. Now, the Federal Reserve can use that power to immobilize some portion of the excess reserves until it can remove them from the balance sheet through other means.

Here is how it would work: By increasing the interest rate paid on reserves, the Federal Reserve can also raise the federal funds rate while holding the same level of reserve supply as before. That's because the interest rate on excess reserves puts a de facto floor under the demand for reserves in the banking system—banks won't want to trade with one another at the federal funds rate, even as it rises, if they can get a better rate by keeping excess reserves on deposit at the Federal Reserve.



Source: Federal Reserve Board.

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Hypothetical Example: Increased Interest on Excess Reserves

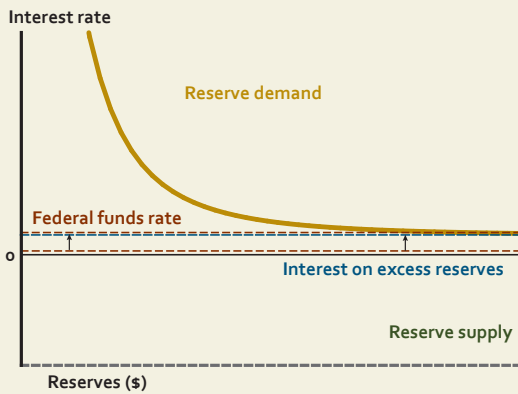


Figure 3. As the economy recovers, the Federal Reserve may want to continue increasing the federal funds rate. To do so, the Federal Reserve could first raise the interest paid on excess reserves. Then, to manage the supply of bank reserves, any or all of three other tools could be put to use:

- 1) Term deposits—banks put money on deposit for a specified term, such as three months.
- 2) Reverse repos—the Federal Reserve lends out securities from its portfolio and banks use reserves on deposit as payment, keeping those reserves out of the marketplace.
- 3) Redemption of maturing mortgage-backed securities or their outright sale—with sales, banks pay for the securities by having their reserve balances debited.

The effect is that the federal funds rate moves up, reserve supply drains from the Federal Reserve balance sheet (or to the left, graphically), and inflation stays under control.

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Hypothetical Example: Term Deposits, Reverse Repos, Asset Sales, and Increased Interest on Excess Reserves

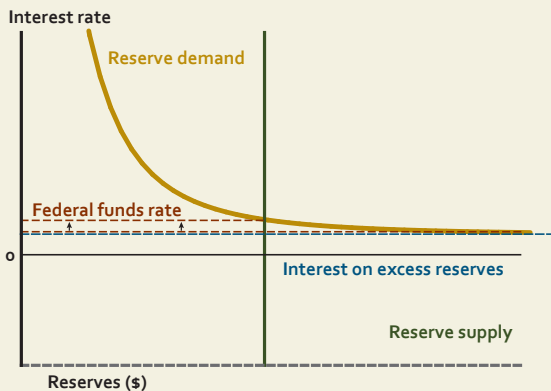
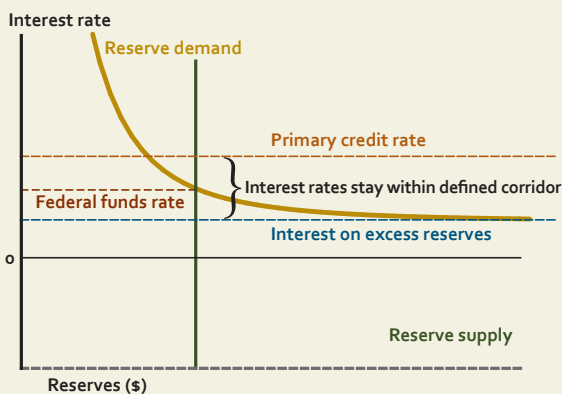


Figure 4. As the economy continues to recover, the reserve supply moves farther to the left, much more in line with the level of reserve supply in the banking system before the crisis. Now, smaller movements in the reserve supply will trigger larger movements in the federal funds rate. Under this “corridor system,” the federal funds rate would tend to be bounded at the top by the primary credit rate (or discount rate) and at the bottom by the interest rate paid on excess reserves. ■

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Corridor System



Source: Federal Reserve Bank of Cleveland.

Presentation



To hear and see Mark Sniderman’s full presentation, go to www.clevelandfed.org/forefront

Bernanke Testimony



Federal Reserve Chairman Ben Bernanke testified before the House of Representatives on the central bank’s exit strategy on Feb. 10, 2010.

www.federalreserve.gov/newsevents/testimony/bernanke20100210a.htm